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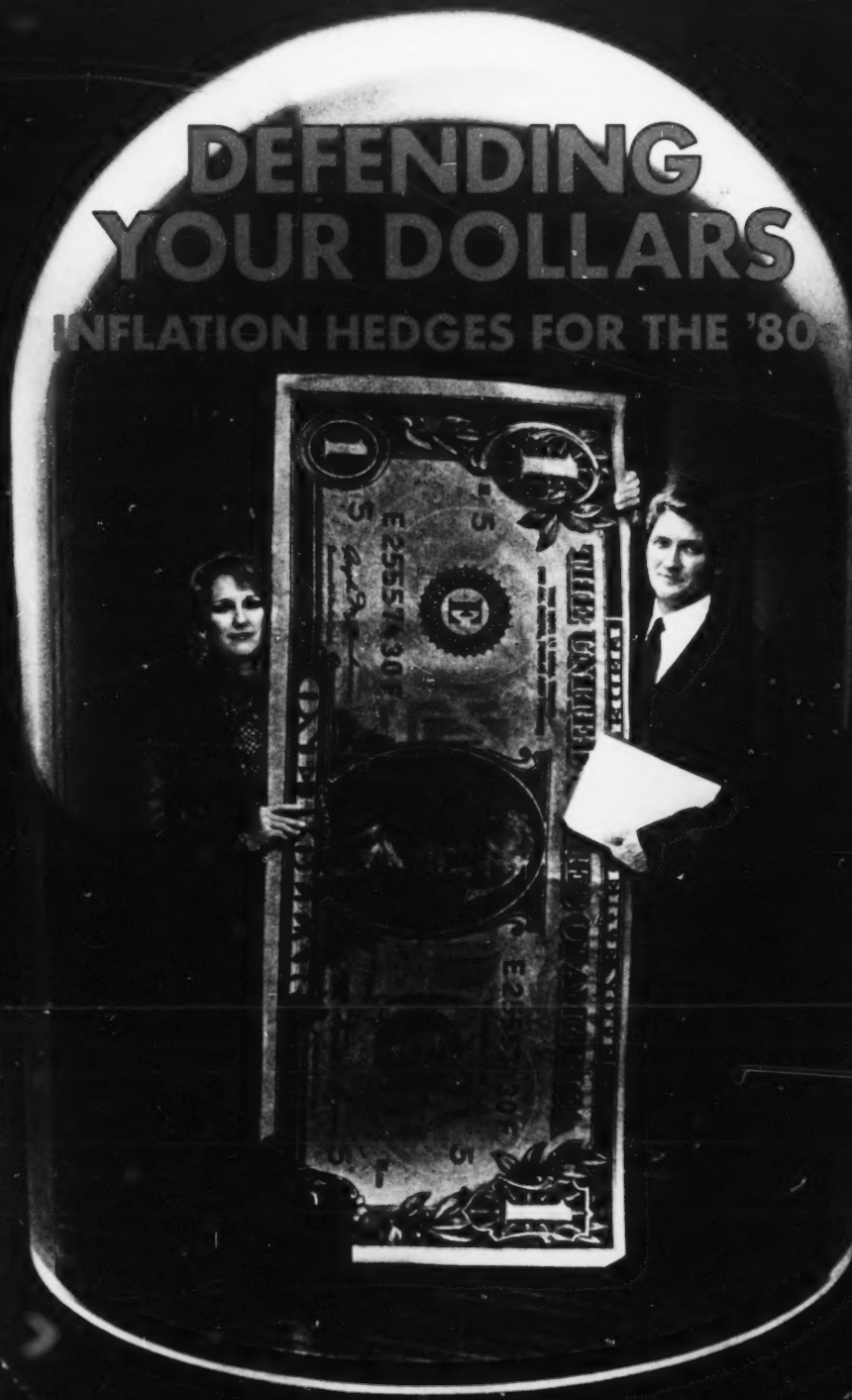
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Putting your money under glass, as depicted in Carl Fischer's cover photograph, probably isn't the best way to hedge against the possibility of renewed inflation. For better bets, see page 30.

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INFLATION HEDGES FOR THE '80s

The definition of high inflation hasn't changed since the last round, but the ground rules for beating it have. A doubling of today's rate, to around 9%, would call for new investment strategies. Collectibles would look worse. Stocks might look better.

■ by *Ford S. Worthy*



Stocks have the eyes in Merrill Lynch's Stamford, Connecticut, office where an overhead screen answers customers' keypunched queries.

WALL STREET isn't exactly worrying itself sleepless over the prospect of high inflation. "Anyone who thinks it's even a possibility better first go see a shrink," giggles one analyst for a large investment firm. Many economists aren't chuckling, however. Inflation is alive and kicking and could come back swiftly if only a few things go wrong (see The Economy).

How far would prices have to shoot up before inflation looked high enough to call for new investment strategies? A doubling of today's inflation rate to about 9%—not far from what moderately pessimistic economists are expecting next year—would certainly do it. Barry Bosworth, who headed President Carter's Council on Wage and Price Stability, thinks the kind of inflationary expectations that would affect the investment outlook erupt when the rate nears 7%.

The U.S. investor who concludes that troublesome inflation is indeed around the corner may be tempted to rush to the shelves and haul down the old strategies he used in the late 1970s. Many of them, he will soon discover, are out of date.

No one needed great financial savvy, for instance, to figure out half a decade ago that almost any package of alternatives offered a better chance to stay whole during double-digit inflation than a 5½% passbook savings account. Nor was genius required to see the other side of that coin: thanks to usury laws now repealed, many consumer loans carried interest rates below the rate of inflation. In effect, the lenders subsidized the borrowers. Cheap money reduced the risk of speculative gambles on precious metals or collectibles and fattened the returns on solid investments like waterfront real estate.

Inflation itself changed the ground rules for dealing with inflation. As it took off during the late 1970s, many investors shifted their savings into money market mutual funds. Then came banking deregulation—provoked, in part, by the discomforts inflation was bringing to the banking system—and with it, a variety of ways for consumers to earn money market rates that approximated the inflation rate. These and other changes have shifted the relative merits of just about all the hedges an investor might consider for the 1980s. The principal choices:

► **THE BANK.** One result is a new anti-inflation strategy of stunning simplicity: leaving your money in the bank. Money market deposit accounts pay interest rates roughly equivalent to the yield of three-month Treasury bills. They require a balance of \$2,500 and limit check-writing privileges. Super NOW accounts pay a percentage point or

RESEARCH ASSOCIATE Daniel P. Wiener

Most analysts see inflation—accompanied by still-higher interest rates—as the biggest threat to stocks. When prevailing wisdom reaches an overwhelming consensus, it's usually time to wonder about the alternatives.

two less, but let you write all the checks you want. Certificates of deposit—available in amounts as low as \$500 and at maturities as short as three months—can offer yields comparable to those of T-bills.

► **TREASURY BILLS.** Banking your money promises to leave you roughly whole when inflation takes off and requires neither effort nor risk. But short-term Treasury bills—the shorter the term the better—traditionally give investors who can put up at least \$10,000 a slight edge on inflation over time. Some of the most interesting new hedging opportunities are designed for institutions and sophisticated investors—though like many other recent financial innovations, they could eventually spread into the consumer marketplace.

Dimensional Fund Advisors, a Chicago-based investment outfit, introduced a mutual fund last summer designed by Eugene F. Fama of the University of Chicago, one of the leading researchers on the relationships between short- and long-term interest rates of debt securities. The appropriately named Inflation Hedge Portfolio is aimed at taking advantage of the higher yields that longer-term securities earn, while maintaining the character of an inflation-hedging, short-term T-bill. The fund typically holds securities whose average maturity is four to nine months and so far has been realizing a premium over one-month T-bills of between one and two percentage points.

► **FUTURES.** These are also mainly for institutional investors, although until 1979, when Treasury bond futures took off, money managers were generally inexperienced in futures trading. A lot of other inflation-sensitive futures contracts have since sprung up, based on everything from CDs to Eurodollar certificates. Even conservative pension fund managers, who used to view the trading floors as gambling casinos, have begun to hedge their bets with them.

Perhaps the most literal-minded inflation hedge is a futures contract pegged directly to the consumer price index. Devised by the Coffee, Sugar & Cocoa Exchange, the CPI

contract awaits approval by regulators. Companies whose labor contracts have built-in cost-of-living increases, for example, could buy futures that tracked the CPI. The proposal is endorsed by Nobel laureate economist Paul Samuelson, and rival exchanges are trying to devise competitive contracts.

► **REAL ESTATE.** A staple of the last inflationary cycle, real estate remains attractive—although the combination of higher interest rates and new tax laws means it will have to be approached somewhat differently.

Commercial real estate combines the virtues of a productive asset with those of a store of value. Rents not only yield income but add to resale value as long as they keep up with inflation; appreciation is taxed at low capital gains rates, and the investor gets to pay off his debt with cheaper dollars.

The real estate industry has become adept at indexing costs to inflation. Most commercial leases signed today have some form of acceleration clause that calls for the rent to go up periodically to help offset expected inflation. But returns on real estate deals over the past ten years have increasingly come from price appreciation and tax treatment. The tax act of 1981 vastly speeded capital recovery through more favorable depreciation rules. Commercial buildings that under the old rules would have been depreciated over 30 or more years may now be charged off in 15 years. One problem is that the better tax treatment has sucked in floods of money from limited partnership tax shelters, driving up the cost of some deals so much that they make sense *only* from a tax angle.

Home ownership won't produce quite the returns it did before fixed-rate mortgages began disappearing from the landscape. Nearly half of all new U.S. mortgages are tied to rates that vary with market interest rates. But owning your home is still a good inflation-hedging investment, primarily because mortgage interest payments are tax deductible, and any appreciation that occurs is usually tax exempt.

► **STOCKS.** The investor attuned to thinking differently about the next inflationary upswing will want to ask some of his most searching questions about stocks. The prevailing wisdom prior to the early 1970s was that stocks were one of the best hedges against inflation. By the end of the decade, shaken investment advisers had recanted utterly, save for a few forlorn but accurate brokers who kept chanting that the present was clearly the best time to buy stocks since they were so undervalued. Today most analysts see inflation—accompanied by still-higher interest rates—as the biggest threat to the market. When prevailing wisdom reaches an overwhelming consensus, it's usually time to

MONEY & MARKETS

start wondering about the alternatives.

One good reason to think differently about stocks and inflation is that companies are generally in better shape than they were in the late 1970s. Government regulation does not threaten to impose as many new costs in the future. Having become more energy efficient during the oil shocks of the 1970s, corporations are less likely to be overwhelmed by any future jumps in energy costs.

Doubt remains about some of the vaunted productivity gains the recession was sup-

posed to have brought about, but managers have improved their operations in other important ways. Many industries have measurably lowered their breakeven points and trimmed overhead. Companies are taking advantage of tax changes enacted in 1981 that allow faster depreciation charges that more closely reflect replacement costs—and in some cases exceed them. They are financing more investment out of cash flow, and have strengthened balance sheets by issuing more equity and less debt. Double-digit inflation

also taught managers how to base decisions on real, or inflation-adjusted, information. Inflation-sensitive assets like cash and receivables are closely monitored, often daily, by companies of all sizes.

Sounder management should yield higher profits, which in turn might produce fatter dividend checks—perhaps leading even stubborn skeptics to reconsider the notion that inflation hurts stocks.

Alternatively, the skeptics could grab hold of a theory that explains how stocks performed reasonably well against inflation for much of this century: put simply, it's that inflation doesn't affect stock returns at all. Gene Fama contends that the high negative correlation between stock returns and inflation is spurious. He finds a more important correlation between one year's real return on stocks and the following year's change in real gross national product. The returns, he argues, depend mainly on how investors see next year's economy shaping up—a forecasting job they seem to do rather well.

Fama's theory hasn't many adherents on Wall Street, but it makes room for a correlation between the miserable performance of stocks in the 1970s and factors other than inflation. In this analysis, stocks were mainly hurt by uncertainties about future costs raised by such external forces as OPEC, environmental regulations, and deregulation. These particular uncertainties have largely waned, suggesting a brighter future for stocks in the 1980s—although an investor will need to judge whether the uncertainties of the 1980s could produce equally high unexpected costs.

Whether such contrarian thinking pays off, of course, depends largely on how long it remains contrarian. If the market continues to reject it, investors will be back to basics. They'll have to sort out companies, or classes of companies, that seem likely to outperform others during inflationary times. Perhaps because the subject hasn't been getting much thought recently, most analysts tend to recommend familiar-sounding strategies. Most favored are companies with lots of tangible underlying assets—coal reserves, timberland, silver deposits.

Productivity plays could become sought after, however. High-tech companies—semiconductor manufacturers, for example—have a demonstrated ability to keep lowering costs, so they don't have to raise prices frequently. But some smokestack industries could produce pleasant surprises. If automakers hold to the courses they have set, their tauter organizations and lower break-



Staking an early gold claim was relatively cheap in the inflationary 1970s, when interest rates were low. Now investors will have higher holding costs to think about before rushing into the market.



Home is where the heart is, but it's also been a good investment during rapid inflation. As the chart on the facing page shows, returns on housing exceeded increases in the CPI during inflation.

even points should help them stay profitable in the face of inflation—and import competition. Exporters should benefit, too, as inflation causes the dollar to fall.

► **COLLECTIBLES.** The best argument for thinking hard about stocks may be that so many other formerly attractive alternatives look less sure. Collectibles, for example, were so hot the last time around that a few years ago John L. Marion, the president of Sotheby Parke Bernet Inc., was besieged by financial managers asking for his assistance in putting together funds of collectibles. He told them their schemes would never work: "People buy these things because they like them and want to own them." Few if any collectible funds materialized, but plenty of individuals wound up buying art or Tiffany lamps as investments—only to realize that they didn't pay any dividends or even always have a market of interested buyers.

► **GOLD.** Even the case for gold appears relatively uncertain. Gold has proved itself a superior store of value for thousands of years, though not in the 1980s, and has outpaced inflation since 1974. Its problem these days is the high cost of money. Most gold is bought with borrowed money, and dealers and banks typically charge three percentage points over the prime rate. Storage, insurance fees, and sales commissions add approximately three more percentage points. Real interest rates—derived by subtracting the inflation rate from the prime rate—were about 2% five years ago; today they are closer to 7%. An investor who bought gold in 1979 would have stayed even with inflation if its value in real terms had risen only 8% or so a year. To keep up today, an investor needs at least a 13% return. A fall in rates would make gold more affordable but would also diminish the main reservation the market has about the value of stocks.

Gold might nonetheless appear to offer interesting speculative possibilities—who can forget its dazzling rise back in early 1980? Some experts think the drubbing many investors took during gold's no less dazzling fall will keep many would-be players away. Others see a wider market in the making. Most large banks and brokerage houses now offer some way to invest in gold. While the metal has always been precious to the masses, Wall Street has put an even more respectable polish on it by endorsing it so heavily over the last few years. In January, Citibank announced that Visa and Mastercard holders can buy gold and silver bullion with a mere phone call. Citibank will buy, store and insure, deliver if you like, and sell your gold when you're feeling more kindly toward, say, stocks. At Merrill Lynch you can invest as little as \$50 at a time after

you make an initial \$100 purchase.

Easy access could have interesting price implications if everybody decides to hold a nugget or two. Says R. Leslie Deak, the president of Deak-Perera, the precious metals and foreign currency trading firm: "The demand would outstrip supply. This makes me believe that under another rapid inflation scenario the increase in the price of gold would be even more dramatic than in 1980."

So, presumably, would the fall. One of the major differences between the inflation of the 1970s and a new bout in the 1980s is apt to be its duration. During the run-up of the late 1970s, investors and policymakers alike

were seized with a sense that the upward spiral was probably unstoppable. But the U.S. finally did come to grips with inflation. Pain there was, but terrible and apocalyptic things did not happen. So the national will for containing inflation will probably be stronger next time, and the response of policymakers quicker and firmer.

The prospect of a sudden shift to disinflation should at the very least increase the danger attached to precious metals, gems, collectibles, and other tangibles subject to speculative fevers. A successful inflationary strategy for the 1980s will have to include a judicious consideration of downside risks. ■

ASSET	DURING INFLATION		DURING DISINFLATION	
	COMPOUNDED ANNUAL RATE OF RETURN, 5 YEARS, 6/76-6/81	RANK	ONE-YEAR RATE OF RETURN, 6/82-6/83	RANK
U.S. stamps	32.9%	1	(6.2%)	10
Gold	30.7%	2	28.6%	4
Chinese ceramics	30.7%	2	0.0%	8
Silver	20.1%	4	109.5%	1
Diamonds	16.9%	5	0.0%	8
Old masters	16.8%	6	1.7%	7
Housing	11.6%	7	2.1%	6
Stocks	9.8%	8	51.8%	2
CPI	9.7%	9	3.9%	5
Bonds	1.1%	10	39.0%	3

SOURCE: SALOMON BROTHERS

The Two Faces of Hedging

Gold and collectibles soared from 1976 to 1981, but stocks and bonds were winners once prices slowed. Precious metals' disinflationary luster is part illusion: their prices bottomed out in June 1982. Figures for the CPI represent returns on an investment that perfectly reflects the index's rise.



Chagall's "Hommage au Passé," at Doyle Galleries in New York, has done well as an investment. But the best reason to bid at Doyle's auction in May is because you want it on your wall.

DEALS

U.S. STEEL AND LTV FIND HIDDEN CHARMS IN LOSERS

Both companies repeatedly said they wanted to reduce their dependence on steelmaking. Yet here they are getting in deeper—and wrenching themselves financially to do it. The excuse they lean on is something called “rationalization.”

■ by Carol J. Loomis



THE TWO GIGANTIC steel deals in the works—the merger of Republic Steel into LTV Corp. and the acquisition of National's steel operations by U.S. Steel—are understandable enough for two of the companies involved. Naturally Republic and National would want to sell out: together, over the last two years, they lost more than \$1.2 billion on steel, and who needs businesses like that? The harder to answer question is why LTV and U.S. Steel would want to buy.

The pair certainly are not reaching out in steel because they have been doing well in that business themselves. In 1982 and 1983 LTV's steel company, Jones & Laughlin, had total operating losses of \$499 million, an amount that more than wiped out J&L's profits in the two previous years. U.S. Steel's pretax losses on steel in 1982 and 1983 were still greater—roughly \$1.5 billion, including a write-off of more than \$1 billion arising from

the company's recent decision to close down about one-sixth of its steelmaking capacity. The two years put the clincher on an abysmal decade for the country's biggest steel producer, in which the years of black ink didn't begin to compensate for the red. All told, before tax credits, U.S. Steel lost around \$1.8 billion on steel in the decade.

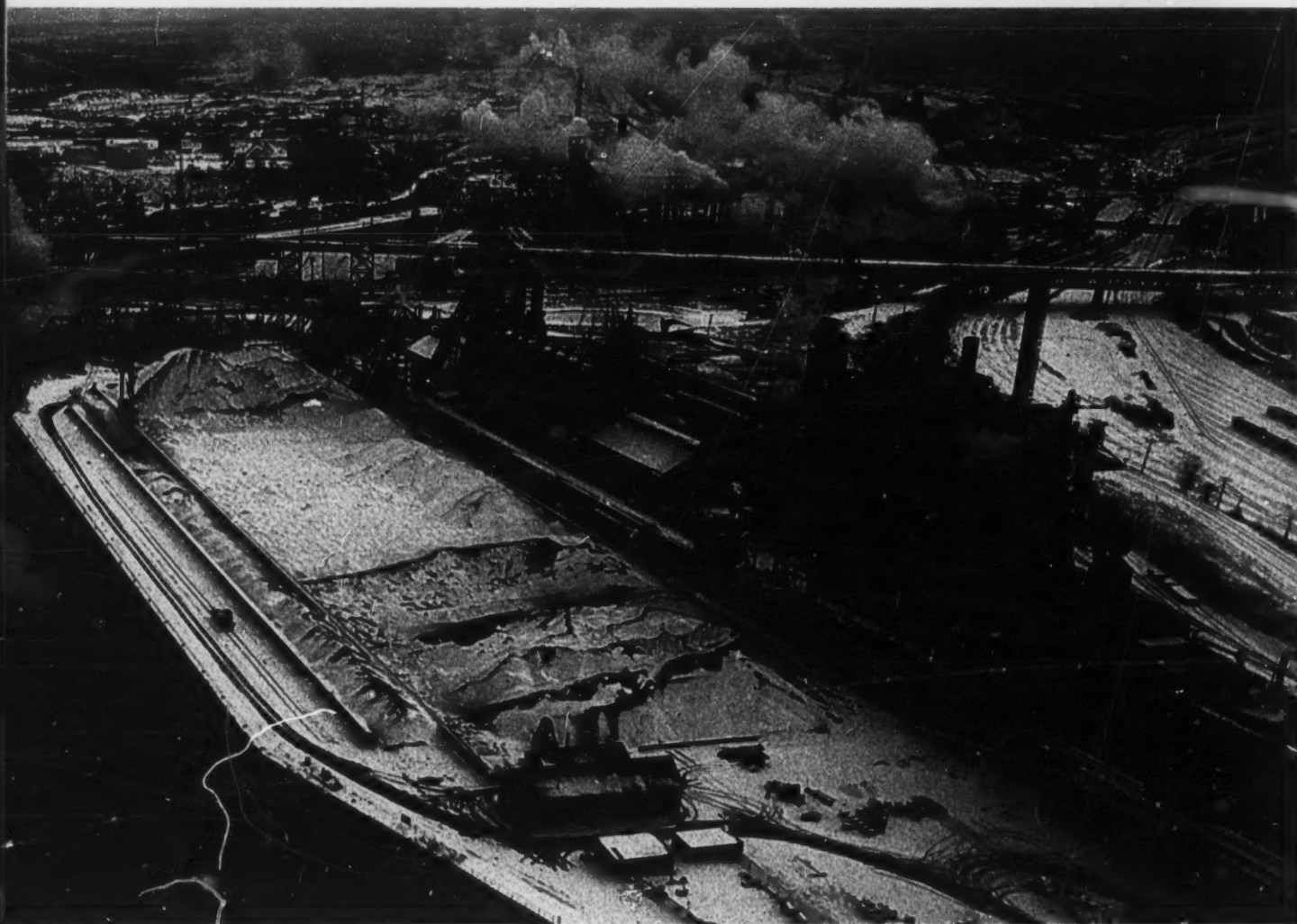
In the midst of it all, both companies declared their firm intent to reduce the importance of steel in their business mix. LTV tried and failed to buy planemaker Grumman, expanded otherwise in aerospace and defense products, and, until the market evaporated, coined money selling oil field equipment through a subsidiary called Continental Emsco. Playing the energy game also, U.S. Steel shouldered a mountain of debt and bought Marathon Oil, transforming itself into a company that gets more than half its sales from petroleum products. All the while, LTV and U.S. Steel vocalized their unhappiness

with steel, deploring the cold, hard facts about the U.S. industry: it is a mature commodity business, short on capital and modernized facilities, beset by high labor costs and foreign competition.

And yet here the two companies are, proposing to expand in steel, and furthermore wrenching themselves financially to do it. To buy Republic, LTV will hand over common and convertible preferred stock recently valued at some \$700 million. That's only about 60% of Republic's book value, but LTV will also assume around \$800 million of Republic debt, to be piled on top of about \$1.6 billion that LTV itself carries. The combined company will end up with debt that is close to 60% of total capitalization—though if that sounds uncomfortable it is no thinner ice than LTV is used to.

The final details of the deal between U.S. Steel and National Intergroup (until last year, known less amorously as National

Riverbank neighbors, Republic Steel's Cleveland mill (on the left) and LTV's (on the right) will be run as one if the companies merge.



DEALS

COMPANY	1983 SALES		1983 LOSS	1983 STEEL PRODUCTION		STEEL EMPLOYMENT		
	Billions	Percent from steel	Millions	Millions of tons of raw steel	Percent of capacity utilized	Peak during past ten years	1983	Percent decline
U.S. STEEL	\$17.5	34%	(\$1,161)	14.8	47%	116,400 (1974)	74,500	36%
NATIONAL	\$3.0	79%	(\$154)	5.3	81%	33,000 (1974)	12,000	64%
LTV	\$4.6	64%	(\$181)	7.7	57%	50,000 (1979)	21,200	58%
REPUBLIC	\$2.7	98%	(\$326)	6.3	58%	44,000 (1974)	26,500	40%

Steel Has Been a Hard, Hard Business

The four companies involved in the two big steel deals rang up combined losses of \$1.8 billion last year, counting write-offs at U.S. Steel, National, and Republic. But National's good operating rate—81% of capacity—enabled that company to make money on steel production, which the other three did not. Republic's near-total dependence on steel has made it especially vulnerable to the industry's slumps, though the energy subsidiaries of U.S. Steel and LTV have recently proved unreliable props also. National's 1983 sales and production figures include results at its

red-ink Weirton, West Virginia, plant for the year's first four months, after which National sold the plant to Weirton's employees; National's 1983 loss includes only a \$100-million portion of the losses incurred in the disposal of Weirton. Displaying palpable relief, a U.S. Steel spokesman says, "Our deal with National is Weirton-free." The 1974 peaks in employment for three of the companies reflected huge demand for steel, partly a result of over-accumulation of inventory by customers. LTV's peak employment followed its acquisition of Youngstown Sheet & Tube in late 1978.

Steel) have not yet been announced. But it appears that U.S. Steel will pay \$575 million straight out—an amount that one competitor estimates is roughly the book value of the steel operations being acquired—and assume debt from National that has a present value of about \$350 million. The \$575 million will be a package made up of cash and preferred stock (at least part of it convertible), with the precise split to depend on U.S. Steel's ability—and willingness—to raise money by selling common stock in the market. The willingness may be the tough part, since the stock has recently been selling under \$30, not much better than 60% of book value. If U.S. Steel accepts such a price yet pays book for National's properties, it will be making a rather unbalanced trade.

FURTHERMORE, the assumption of debt in that deal and also in LTV's does not tell the full lurid tale about liabilities. Both companies will also be assuming pension obligations. The details of what U.S. Steel is getting from National haven't been revealed, but the pension plans passing from Republic to LTV are substantially underfunded. Beyond that, steel balance sheets simply ignore the potential effects of plant closings, which dramatically increase pension burdens. So U.S. Steel and LTV are taking on potentially large liabilities not even mentioned in the company announcements of the deals.

The excuse for all this is "rationalization," a word used by both U.S. Steel and LTV to

RESEARCH ASSOCIATE *Willon Woods*

explain the logic of their deals. But the term plainly does not have precisely the same meaning at LTV Tower in Dallas as it does at U.S. Steel's headquarters in Pittsburgh.

The thinking at LTV was recently described by its 53-year-old senior vice president for finance, James J. Paulos, who is the designated spokesman about the Republic deal. A veteran of 28 years in the steel business, Paulos is stark in his assessment of it: "You start from the premise that nobody has any particular interest in becoming bigger in steel per se. You also start with the perspective that almost anybody, given an acceptable price and acceptable business alternatives, would have an interest in divesting steel."

But no generous offers have been showered on LTV, and in early 1983 it stepped up a search for other means of relief. Merger seemed a possibility, for an odd reason. Putting two steel companies together, says one Wall Street expert on the steel industry, is like taking two old cars and combining the best parts of each. "You end up with one car that's not bad. True, it's not new. But by merging you cut costs, avoid some capital investment, and buy yourself some time."

From LTV's standpoint, the most compatible car around, so to speak, was Republic, No. 4 in the industry to LTV's No. 3. The two companies basically make the same products—sheet steel, bars, seamless pipe, and stainless steel—and if you're trying to cut costs, commonality is a virtue. In addition, Republic was financially weak and grow-

ing more so. Needing help of some kind, it was ready to talk merger.

The negotiations blew hot and cold, however, says Paulos, and for a time even contemplated that Republic might acquire J&L, instead of LTV being the buyer. "So," says Paulos, "we had three questions to look at. Should we sell J&L? Should we do nothing with respect to Republic? Or should we acquire Republic?"

A PROBLEM WITH SELLING J&L, says Paulos, was that Republic, strapped for cash, could offer only stock as payment. That meant LTV wouldn't be getting out of steel if it sold, only giving up direct control. A further drawback was the character and weight of the aerospace and energy businesses that LTV would be left with. In LTV's opinion, they would not have supported the company's stock price (now about 80% of book value) or provided the cash flow to service the parent company's debt, which amounts to about half the \$1.5-billion total. That proposition has its ironies, since right now steel is not up to supporting anything. But LTV had a recent year, 1981, in which it made \$336 million on steel (much of it earned on seamless pipe sold to the oil industry). The company's thoughts inevitably focus on a return to such days.

The decision, then, was not to sell out to Republic, but instead to keep drumming along in steel. "Once you come to that conclusion," says Paulos, "you're really back to the way we've been playing steel all along.

DEALS

You've got to maintain your competitiveness." And that moved the question to whether the acquisition of Republic could improve J&L's position. Yes, said the LTV analysis: "very large benefits" would flow from the combination. Of course, adds Paulos, the deal could not be done were LTV required to pay cash, rather than stock. (The form of payment, naturally, will leave Republic's shareholders at the moment of merger still in the steel business, though it also provides them with diversification because of LTV's operations outside steel.)

Some of the "very large benefits" will be

whose furnaces could operate more efficiently with the added load. The effort was an impressive success. At its conclusion, the J&L-Youngstown combination had less stated steelmaking capacity than it had started with. Yet barring a boom market for American steel—O foolish dream!—the companies had retained a practical ability to serve their customers fully. They, in fact, lost none of the market share they had enjoyed as separate companies. The savings, meanwhile, added up to about \$100 million annually, or around \$15 a ton on an average year's production.

And that, says Paulos, is "rationalization,"



Low-cost leaders, National's steel plants make heavy use of continuous casters, such as this one at the Great Lakes works. National makes 60% of its slabs on casters, U.S. Steel only 18%.

the normal variety arising from a horizontal merger: two sets of administrative costs will be whittled to one. But the greater savings are expected to arise from manufacturing efficiencies, as J&L's 13 million tons of capacity and Republic's ten million are meshed. In that line of endeavor, LTV has experience, born out of its work in putting J&L and Youngstown Sheet & Tube together after the 1978 merger between LTV and Lykes Corp., which owned Youngstown.

On that occasion, J&L shored up operations at one Youngstown Sheet plant—Indiana Harbor, outside Chicago—and made the mill a source of raw steel for J&L's finishing facilities in Hennepin, Illinois. The blast furnaces at the other Youngstown Sheet plant—at Youngstown, Ohio—were shut down and its finishing mills were supplied with steel made at nearby J&L facilities,

which is to be contrasted, and devoutly preferred, to "shrinking." To him, shrinking means both fewer mills and less business, accompanied by a grave risk that revenues will drop more sharply than fixed costs. Rationalization, on the other hand, means fewer mills and the same business. "That's the only quarrel I have with the used-car analogy," says Paulos. "It leaves you running one car instead of two, and to me that sounds like shrinking."

Because the Department of Justice is right now considering the antitrust implications of this proposed merger (on which it is expected to rule before the end of February), LTV is sparing with details about the rationalizations it has in mind. But the list of things Paulos is willing to talk about begins with production in Cleveland, which forms, says one knowledgeable Wall Streeter, "the heart of

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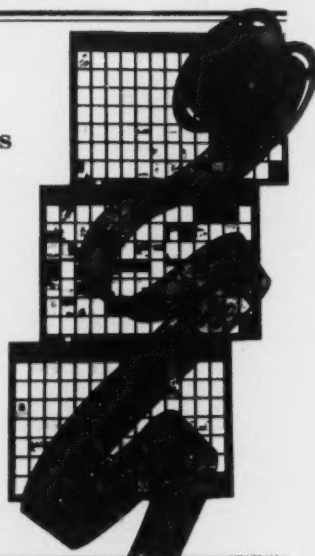
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DEALS

the merger." Both companies have large mills in the city and they are located right across the Cuyahoga River from each other—as the fish swims, no farther than 100 yards apart. After the merger, assuming it comes, the combined company will run the two plants as one, using the most efficient facilities of each.

Further rationalizations, says Paulos, will derive from three plants—in Chicago, in Aliquippa, Pennsylvania, and in Canton, Ohio—where Republic and J&L variously make bars and seamless pipe. Three plants are one too many, asserts Paulos. But he isn't prepared to say which will be closed or when.

NOR WILL HE PUT a figure on the savings that may ultimately be wrung from these rationalizations and others the companies have in mind. He will only predict "very substantial" gains. Wall Street's estimates range from about \$200 million annually to \$700 million. Analysts in the upper reaches of that range, implies Paulos, have let themselves get carried away.

Summing up the case for the merger, Paulos says that the savings, whatever they turn out to be, could not have been attained by either company operating separately. On their own, he claims, neither J&L nor Republic would have the ability to close down major steelmaking operations while retaining an adequate revenue base. His point is supported by Father William T. Hogan, a Fordham University professor of economics who is an expert on steel: "It's simply easier to pare down one 23-million-ton company than two of half that size."

The point suggests that U.S. Steel, still a 26-million-ton company after its write-offs, might have been big enough to work out its rationalization internally rather than through purchase of another company's steel operations. No designated spokesman materializes to explain the choice: pending a review by the Department of Justice of the plans, the company's top executives have made themselves unavailable to the press. However, the head of steel operations, Thomas C. Graham, did appear before New York security analysts on February 1 to announce the bombshell. The reaction he got, says John Gagliano of Paine Webber, "was shock and a deafening silence." Some analysts were no doubt mentally trying to absorb the thought that U.S. Steel was actually proposing to expand in steel. Others may have been asking themselves how U.S. Steel could ever expect Justice to condone this transaction—the

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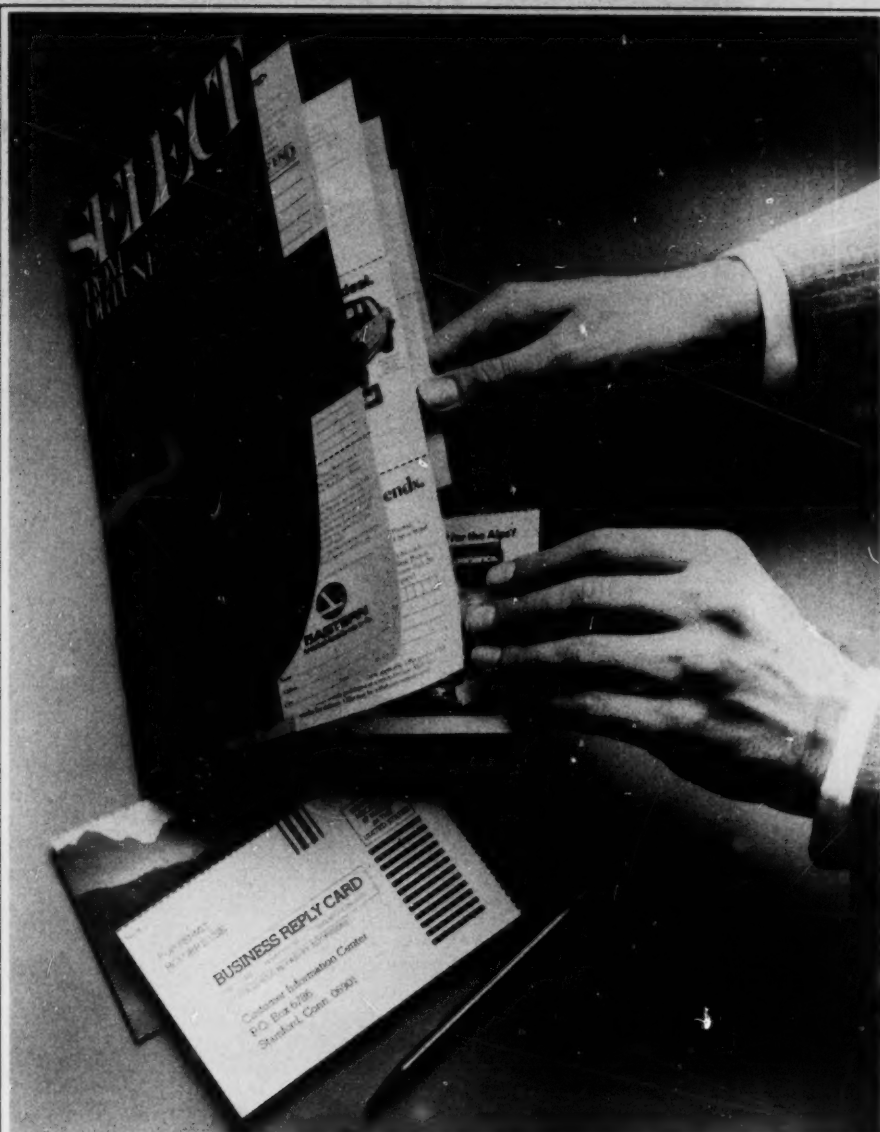
No. 1 steel company (carrying a name that, rightly or wrongly, connotes power) buying the seventh-largest steel operation.

To that bowled-over audience, Graham presented U.S. Steel's rationale for the deal, which turns around the fit between the two operations: National's core business is sheet steel, sold mainly to automobile and appliance companies; U.S. Steel is an also-ran in that business. National is short on coke; U.S. Steel is long. National needs slab steel; U.S. Steel has excess capacity that can supply it. Some synergies should be possible between U.S. Steel's Gary, Indiana, plant and a nearby National finishing mill. All together, according to U.S. Steel, annual savings of \$170 million look feasible, to be garnered equally from raw materials, administration, and operations. Moreover, National has some of the industry's most modern plants, to be acquired by U.S. Steel at a cost of about \$200 an annual ton of capacity. That compares, U.S. Steel says happily, with costs of perhaps \$1,800 to \$2,000 per ton for a new, or "green field," plant.

The comparison is somewhat irrelevant: no one talks these days about building a green-field steel mill in the U.S. Nor does this seem to be a pure case of combining two old cars to make a better one. Instead, U.S. Steel appears to covet National's roadster, which in a relative sense has been burning up the road. Last year, enjoying the strong market in both cars and appliances, National actually operated at 81% of capacity, its best level since 1974.

That performance, though, took place in an environment of weak prices and produced only \$22 million in operating profits (before write-offs that sank National's steel division deep into the red). Even profits in National's best quarter, the fourth, were anemic, \$31 million. Pretax profits like that are not enough to give U.S. Steel an adequate return on its proposed investment of more than \$900 million. To make this deal worthwhile, U.S. Steel must obtain a lot of the savings it is projecting.

THE APPARENT ARCHITECT of this deal was Tom Graham, whom Chairman David Roderick brought into the company last May. Before that, in an interesting chain of events, Graham ran J&L, where he participated in (and reportedly applauded) the beginning rounds of talks with Republic. Graham, 57, is respected for the job he did integrating Youngstown Sheet into J&L and for improving labor relations and productivity at J&L. He is also out of the



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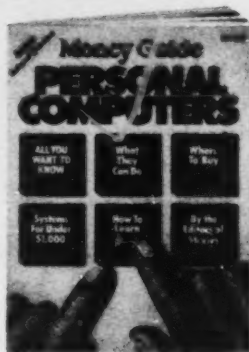
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DEALS

school that believes profoundly in market share. In a speech he gave in September to analysts, he noted that U.S. Steel had lost about five percentage points in share between 1979 and 1982 (dropping to a 16% share of American steel shipments) and stated his intention to regain position. The National deal, though an unorthodox way to climb, would indeed restore the five points and a bit more.

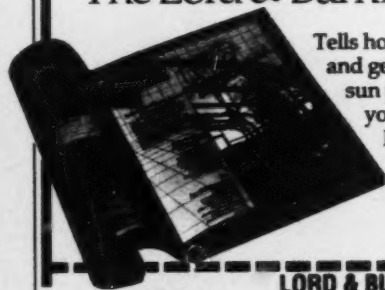
A U.S. Steel competitor, who appears to admire market share himself, says the company's plans to strengthen its position in sheet steel are intelligent: "It points them in the direction all steel companies have to go." But Jim Paulos says that he, for one, would not have chosen U.S. Steel's strategy. He speaks, again, out of his "inherent aversion to getting bigger in steel." Says Paulos: "In my opinion, U.S. Steel has other options—investment in oil, say, or chemicals—that make more sense." Even some U.S. Steel executives appear to agree with that. Rumblings of displeasure about the National move have escaped Big Steel's offices.

THE TIMING of U.S. Steel's announcement, and particularly the company's decision to go public with the deal before its terms were completely worked out, inevitably raise the thought that it wanted to get its proposal on the table before Justice ruled on the LTV-Republic merger. Perhaps U.S. Steel thinks its case would be weakened if it came along later, as a kind of me-too item. Some analysts also advance a conspiracy theory, which postulates that U.S. Steel doesn't have much hope of gaining Justice's approval, but intends by its arrival on the scene to impede the LTV-Republic deal. It is not really clear, though, why U.S. Steel should want to do that. Both Republic and National have reputations as price-cutters, and competitors might well welcome their prompt disappearance from the market. That proposition could help explain why no major competitors have raised their voices to oppose either deal, LTV's or U.S. Steel's.

Approval from Justice, whatever its other repercussions, would assuredly tie LTV's fortunes to steel. Says Paulos: "As steel goes, so will LTV." U.S. Steel, even with National in tow, could not say as much, since steel would still account for less than 50% of corporate revenues. Some U.S. Steel executives may be deeply thankful for that fact. Still, the company has now reasserted a claim to the name Big Steel. If only it could next get back to making steel at a profit. **□**

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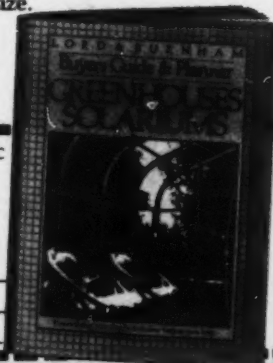
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